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UNCLAS SECTION 01 OF 02 MEXICO 000413

SENSITIVE, SIPDIS

STATE FOR A/S SHANNON  
STATE FOR WHA/MEX, WHA/EPSC, EB/IFD/OMA, AND DRL/AWH  
STATE FOR EB/ESC MCMANUS AND IZZO  
USDOC FOR 4320/ITA/MAC/WH/ONAFITA/GERI WORD  
TREASURY FOR IA (ALICE FAIBISHENKO)  
DOE FOR INTERNATIONAL AFFAIRS (KDEUTSCH AND ALOCKWOOD)  
STATE PASS TO USTR (EISSENSTAT/MELLE)  
STATE PASS TO FEDERAL RESERVE (CARLOS ARTETA)

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SUBJECT: GOM INTERVENES TO STOP SPECULATION ON PESO

1.(U)SUMMARY. The Bank of Mexico (Banxico) announced this week it would continue to intervene unannounced in the foreign-exchange market for the "foreseeable future", as a result of what analysts call "market-driven" speculation. Analysts say the speculation last week had little to do with capital flight or economic conditions, as in other countries. This time, the central bank had intervened directly with banks, rather than open auctions, when they noticed speculative movements by traders last week, which made the peso to depreciate 6.6% close to 15 pesos to the dollar the week of February 12. Banxico governor Guillermo Ortiz yesterday said that the central bank isn't attempting to set the peso at a specific level, though it will continue to intervene should there be excessive volatility. End SUMMARY.

12. (SBU) With close to \$84 billion in reserves, the Bank of Mexico has intervened in regular auctions of \$400 million when the peso has depreciated more than two percent. During last week's selling, the Bank of Mexico reportedly noticed banks, investors and hedge fund operators speculating on a more expensive peso (around 15 to the dollar). A Bank of Mexico official explained to us that using privileged information concerning companies' needs for dollars to pay foreign debt, and knowing the amount of reserves and the current liquidity problems, banks "played" the central bank's auction system for its own profits.

CRITICISMS: TRANSPARENCY?

13. (SBU) The Bank of Mexico's direct interventions have caused Fitch Ratings to be concerned. On February 11, the ratings company noted publicly that the lack of transparency in these dollar injections could cause it to revise Mexico's sovereign debt rating downward. Shelly Shetty, Fitch's Senior Director of Sovereign Debt for Latin America told the media the central bank was jeopardizing Mexico's commitment to a floating exchange rate. However, several analysts said that the amount of dollars directly injected by the central bank was very similar to the auctions of previous weeks. More than setting a fixed exchange rate, the Bank of Mexico is restricting the excessive volatility to stabilize the peso and contribute to financial stability. Complicating factors, especially for outside observers, is the fact that unlike the U.S. Fed or countries in the regional (e.g. Colombia), Mexico's central bank does not make public minutes of its meetings.

14. (U) Local analysts note that the Bank of Mexico's intervention

is not different from what other central banks are doing, particularly in emerging countries. Additionally, Mexico's foreign reserves are still high despite the central bank's interventions. Unlike 1994/1995 the Bank of Mexico now reports the level of its foreign reserves on a weekly basis. There has certainly been capital flight from Mexican bonds to U.S. Treasuries --\$11 billion in the past six months-- given the global situation and risk aversion to emerging markets, but last week's volatility was explained by the speculators' maneuvers.

#### RESERVES STILL STRONG

15. (SBU) Since October 2008, the Bank of Mexico has intervened the foreign exchange market with a total of \$ 17.9 billion, which analysts compare to the amount of foreign direct investment expected for 2008. Last week, the central bank injected \$1.1 billion to prop up the currency. Banxico's foreign reserves fell to \$82.1 billion in the week ending February 6.

16. (U) There have been cases of Mexican companies that have had problems as a result of the weaker peso, but so far the government has been able to tackle that problem with guarantees provided by NAFIN, a Mexican development bank. If need be, the U.S. Fed has also established a reciprocal swap liquidity arrangement for about \$30 million. Finally, in case of extreme distress, the authorities can approach the IMF and borrow up to \$23.5 billion under the recently established Short-Term Liquidity Facility.

#### FUNDAMENTALS ARE STRONG, SAY 32 TOP ANALYSTS

17. (SBU) Despite the global crisis and the U.S. and domestic

MEXICO 00000413 002 OF 002

recession, both the government and the IMF are convinced economic fundamentals in Mexico are still solid this year. Mexico's current account deficit, (Note: projections for 2009 range from 2% to 4% of GDP versus 8% of GDP in 1994), its low foreign debt, revenues associated with the hedging of oil prices during 2009 (estimate of \$9 billion), and the fact that the government's foreign exchange needs are covered by reserves with a ratio of 3 to 1 are all positive factors. Altogether, these facts influenced the positive judgment of thirty-two of Mexico's most important analysts surveyed by the Bank of Mexico in January. This group projected an exchange rate of 13.50 pesos to the dollar by the end of 2009. This is far from the "super peso" (at 9 or 10) of previous years, but reasonably close to current levels (14).

#### COMMENT:

18. (SBU) COMMENT. The Mexican Banking Association strongly denies that the peso will collapse as it did during the 1995 "peso crisis", mainly because companies have less debt in dollars these days. The conventional wisdom here is that the government and financial markets learned the lessons of 1995, and built in the kind of protections that other countries are only now learning about. In addition to market-driven speculation, there is no doubt that the peso will continue to be vulnerable to the more traditional factors, i.e. a deepening recession in the U.S. and its effect on Mexico's real economy such as exports, FDI, tourism and remittances. And as in other currencies, the peso will also react to U.S. investors' confidence or jitters on the impact of the U.S. stimulus package.

BASSETT